No. 21021

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

DENCO DEVELOPMENT CO.,
a corporation,

An Alleged Bankrupt,

Appellant,

vs.

COMMUNITY SAVINGS & LOAN ASSN.,

Appellee.

APPELLEE'S BRIEF

APPEAL FROM
THE UNITED STATES DISTRICT COURT
FOR THE CENTRAL DISTRICT OF CALIFORNIA

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PRELIMINARY STATEMENT

This is an appeal from an order of the United States District Court granting Appellee's Application for Review of an order of a Referee in Bankruptcy which order made certain allowances from funds in the hands of the Receiver and which further provided that the balance of such funds should be returned to the alleged bankrupt. The order granting the Application for Review disallowed the said allowances and awarded the funds in the hands of the Receiver to Appellee. (R.pp. 121-122)

SUMMARY OF FACTS

The alleged bankrupt, Denco Development Co., (hereinafter sometimes referred to as "Denco") constructed a number of apartment buildings in Orange County, which construction was financed by appellee. (Fdg. 1, R.p.110) In September of 1964 Denco was in default on the 101 loans here involved with a total balance due of approximately $3,750,000. Appellee had initiated foreclosure proceedings under its deeds of trust and the trustee sales under such foreclosure proceedings were scheduled for September 30, 1964 at 11:00 a.m. as to 29 of the deeds of trust and for the week of October 12, 1964 as to the remaining deeds of trust. (Fdg. 2, R.p.111) On September 29, 1964 an involuntary petition in bankruptcy was filed against Denco (R.p.2) and the referee issued a temporary restraining order at 4:00 p.m. that same day restraining appellee from proceeding with the 29 sales set for the following morning. (R.p.7)

Appellee obeyed the temporary restraining order and postponed the scheduled sales. Appellee opposed the continuing in effect of the temporary restraining order each time the matter came on for hearing (Fdg.5, R.p.111) but said temporary restraining order was nevertheless continued in effect until December 17, 1964. (Fdg.7, R.p.112). On October 5, 1964, less than one week after being served with the temporary restraining order, appellee filed its

Application for Order re Sequestration of Rents. (R.p.26) As set forth in said application, the deeds of trust expressly assigned to appellee as additional security the rents, issues, and profits arising from the real properties subject thereto. Appellee requested the referee to direct the receiver to sequester all rents, issues, and profits arising from the property and to hold them for the benefit of appellee. On October 7, 1964, the referee issued an order to show cause re sequestration of rents which covered the 29 deeds of trust hereinbefore referred to. (R.p.28) Thereafter, on October 23, 1964, a stipulation between the receiver and appellee was filed, and the referee made an order, providing that any decision of the referee concerning either the sequestration of rents or appellee's right to proceed with its foreclosure sales should apply to all 101 loans, not merely the 29 first mentioned. (Fdg.8,R.p.112)

While no formal order was made by the referee on the question of the sequestration of rents, the matter was presented to him in open court and in the presence of the alleged bankrupt and its attorney of record. At that time the receiver represented to the referee that the funds arising from the rental of the properties covered by the deeds of trust would be used by the receiver solely for operating such properties and the payment of his costs and fees, and the balance would be held for the benefit of

appellee and would not become part of the general assets of the alleged bankrupt's estate. This procedure was acceptable to appellee and no objection thereto was made by either the referee or the alleged bankrupt. (Fdg.11, R.p.113) Thereafter, on December 17, 1964, appellee and Denco stipulated, and the referee so ordered, that the temporary restraining order of September 29, 1964 could be dissolved and appellee allowed to proceed with its foreclosure sales under its deeds of trust. (Fdg.14, R.p.114) Appellee agreed to waive any right it might have to recover any deficiency judgment under its deeds of trust.

Appellee did thereafter proceed with its foreclosure sales and acquired the properties at such sales. The total amount bid on behalf of appellee consisted of the principal amount due, the interest thereon, and the trustee's fees and expenses relating to said sales. However the amount bid by appellee did not include other items which were secured by said deeds of trust, consisting of the fees paid by appellee to its appraiser in connection with appellee's efforts to secure the dissolution of the temporary restraining order, which fees amounted to $6,000, the fees paid by appellee to its attorneys in connection with their efforts to obtain the dissolution of the temporary restraining order and the sequestration of rents, which fees amounted to $5600, and the default charge

of one-fifth of 1% on the unpaid balance, which amounted to some $7500. The total of said three items not included in the bid was $19,100, which sum exceeded the amount in the hands of the receiver for distribution. (Fdg. 16, R.p.115) The funds held by the receiver amounted to something in excess of $11,000 after certain allowances not here involved. (R. pp. 95-97)

ARGUMENT

The District Court held that the funds in the hands of the receiver which arose from the operation of the improved properties encumbered by the deeds of trust under which appellee was the beneficiary, were held by said receiver for the benefit of appellee subject only to the expenses and fees of said receiver and those services which contributed to the creation of said fund. The District Court further held that appellee was in constructive possession of the property secured by the deeds of trust. (Concl. 2, R.pp.118-119) Appellee submits that the order of the District Court should be affirmed for three separate and independent reasons:

1. The funds in the hands of the receiver were at all times material hereto the property of appellee, subject only to the fees and expenses of the receiver, and accordingly, such funds should have been paid to

appellee regardless of the merits of its claims concerning its right to recover the taxes, attorneys' fees and other expenses incurred by it.

2. Assuming solely for the purposes of this argument that the funds were not the property of appellee, still appellee is entitled to recover the taxes, attorneys' fees and other expenses incurred by it which were secured by the express terms of the deeds of trust and which were not included in the amount bid by appellee at the foreclosure sale.

3. Finally, a portion of the appraisal fees were paid prior to the foreclosure sales and all of said appraisal fees, as well as the major portion of the attorneys' fees, were for services rendered prior to the foreclosure sale and appellee should be reimbursed for those items in any event.

I

The Funds in the Hands of the Receiver at All Times Material Hereto Belonged to Appellee

There is no question that all the funds in the possession of the receiver arose from rents collected by the receiver from the improved properties which were mortgaged by the alleged bankrupt to appellee.

The deeds of trust covering these pro-

perties provided that, in the event of any default in payment of any obligations secured by such deeds of trust, appellee might at any time without notice either in person, by agent, or by receiver, and with or without taking possession, collect such rents, issues, and benefits, and apply the same, less costs and expenses of operation and collection, to the obligation secured by such deeds of trust.

There is no question that it is the general rule that rents do not belong to a mortgagee unless the property has been reduced to the possession of the mortgagee. However, in the instant case, appellee was in the process of obtaining possession of the property, and would have reduced said property to its possession but for the temporary restraining order issued by the referee. Appellee could not proceed with its foreclosure sales as the result of this order and it could not have a receiver appointed to take possession for it because a receiver had already been appointed by the referee and was in possession. Appellee did the only thing it could, which was to apply to the referee to have the rents collected by the receiver sequestered for the benefit of appellee. While no formal order was ever made requiring the receiver to sequester such rents for the benefit of appellee, the receiver represented

to the court that he would apply the receipts from the property to the expenses of operation and to his own fees and services, but that he would hold the balance for the benefit of appellee. Appellee respectfully submits that in this situation there is no question that the funds in the hands of the receiver were held by him for the benefit of appellee and he was, in fact, acting as the agent of appellee in this connection.

A case remarkably similar to the instant situation is that of Mortgage Loan Company v. Livingstone (8th Circuit 1930), 45 F.2d 28, which was cited with approval by this Court in the case of In re Hotel St. James (1933) 65 F.2d 62. In the Mortgage Loan case, the mortgagee had commenced foreclosure proceedings and a sale was set, but an involuntary petition in bankruptcy was filed two days prior to the scheduled sale, and a receiver was appointed and the foreclosure sale enjoined. As in our case, the mortgagee repeatedly sought to have the injunction lifted, but the injunction was kept in force for several months. The mortgagee also filed a petition to have the rentals applied in accordance with the mortgage, but this petition was never formally passed upon by the court, although the receiver informally agreed with the mortgagee that he would so apply the rents. Ultimately, the court permitted the mortgagee to sell the property and there was a deficit

upon such a sale. The mortgagee sought to obtain from the receiver the funds he had on hand which arose from the rents from the mortgaged property less whatever allowance might be made by the court to the receiver for his services. The court denied this request, although it did award the mortgagee the amount of the taxes which had not been paid by the receiver. This order was reversed by the court on appeal, which held that the mortgagee was entitled to the funds in the hands of the receiver. In reaching this conclusion, the court pointed out that it recognized the general rule that a mortgagee was not entitled to rents until he took possession, either in person or by receiver, but went on to note that in this case the mortgagee had been enjoined by the court from enforcing its rights under the mortgage and that the mortgagee had done all it could under the circumstances. The following statement by the court is equally applicable to the instant case.

> ". . . They were, of course, unable to take possession of the property from the receiver, except on an order of court, and the record in this case warrants the conclusion that the receiver was acting not only on behalf of the general creditors, in so far as this property was concerned, but was acting also in

"behalf of these mortgagees, and he collected and impounded these pledged rents and issues, keeping them separate from his other accounts for apparently no other purpose than to make them available as a part of the security under this second mortgage. By carrying on the business of this hotel company through a receivership, the court assumed the burden of administering the property and collecting the income therefrom for the benefit of whomsoever was entitled thereto. This is not a case where the mortgagor was permitted to remain in possession of the property and to receive and disburse the earnings, but is a case where a receiver was appointed, who, at the demand of the mortgagees, collected, impounded, and separately kept these funds. He was their receiver, and nothing was done by him with these funds during his stewardship inconsistent with their application to a discharge of the pledge, and hence it cannot be said that the mortgagees are precluded from asserting their rights thereto by having remained silent, or by having acquiesced in the possession of the property and the collection of the income

"by the receiver, because they were not collected for purposes other than the satisfaction of the mortgage debt." (emphasis added)

A similar result has been reached in other circuits, including this one.

American Trust Co. v. England
9th Cir. (1936) 84 F.2d, 352.

Associated Company v. Greenhut
3rd Cir. (1933) 66 F.2d 428.

In re: Wakey
7th Cir. (1931), 50 F.2d 869.

The District Court determined that appellee was attempting to obtain funds which were held for its benefit by the receiver at all times during the pendency of the bankruptcy proceeding, pursuant to the application for sequestration of rents filed by appellee and the representation and stipulation made by the receiver that he was holding such funds for the benefit of appellee, after the payment of the receiver's fees and expenses. Said court further determined that the action of the appellee in filing the application for the sequestration of rents collected by the receiver was sufficient to impose on the receiver an obligation to preserve the net income for appellee and was all that appellee could do in the circumstances to protect and enforce its

rights in said rentals. (F.32 and 33 R.p.118) This determination was the only proper holding under the facts of this case and under the above-mentioned authorities.

II

The Taxes, Attorneys Fees and Other Expenses Paid by Appellee Were a Proper Charge Against Such Fund

As set forth above, it is the position of appellee, and the holding of the District Court, that the funds collected by the receiver were collected by him for and on behalf of appellee and that such funds therefore were and are the property of appellee and should be delivered to appellee without regard to the question of what credit or credits appellee should give to the alleged bankrupt for such collections and what charges could properly be made by appellee against such funds. However, if this Court should disagree with that position, then nevertheless appellee respectfully submits that it is still entitled to said funds as reimbursement for expenses paid by appellee which were secured by the deeds of trust and which were not included in the amount paid at the foreclosure sales.

Among other things, the deeds of trust provided that they were security for the performance of each

agreement of the trustor contained therein. (Fdg. 15, R.p.114) One of the agreements of trustor expressly set forth in said deed of trust is the agreement to pay before delinquency all taxes and assessments affecting the property. Neither the receiver nor the alleged bankrupt paid the real property taxes for the tax year 1964-1965 although such taxes became a lien on July 1, 1964 and the first installment thereof was due and payable on November 1, 1964. Appellee was required to pay said taxes at a date subsequent to the foreclosure sales, in a sum in excess of $78,000. (R.p.87) We submit that there was, if nothing else, an equitable lien on the funds collected by the receiver for the amount of taxes paid by appellee.

The deeds of trust further provided that the trustor would pay all costs and expenses, including attorneys' fees, in any action or proceeding in which the beneficiary or the trustee might appear for the purpose of protecting or enforcing the security of the deeds of trust and the obligations secured thereby. As a result of the filing of the proceeding and the issuance of the order restraining appellee from proceeding with its foreclosure sales, it was necessary for it to retain attorneys to protect and enforce its security. While it is true that appellee did not pay its attorneys

until a date subsequent to the foreclosure sales, nevertheless it is equally true that appellee was required to retain attorneys and incur an obligation for their fees prior to the foreclosure sales and that such services were expressly directed to protecting and enforcing the security of the deeds of trust and the obligations secured thereby. Appellee paid its attorneys the sum of $5600 for these services during the month of March, 1965. (R.p.88)

The principal issue presented to the referee in connection with enjoining appellee's foreclosure sales was whether there was any equity in the properties or whether the loans secured by the deeds of trust exceeded the fair market value of the properties. The petitioning creditor and the alleged bankrupt both took the position that there was an equity in the property, whereas appellee at all times correctly alleged that there was no such equity. Appellee retained the firm of Marshall and Stevens to appraise the properties and when said firm was finally allowed to testify as to the results of its appraisal, it testified to a value less than the amount of the loans. The appraiser selected by the receiver also ultimately testified to a value less than the amounts secured by the deeds of trust. Very complete and well documented appraisal reports were pre-

pared by Marshall and Stevens and were submitted in evidence at the time of their testifying. Appellee paid said firm the sum of $6,000 for their services in connection with such appraisals. (R.p.88) While we do not consider it significant, we would point out that the sum of $4,000 was paid to said appraisers on November 25, 1964, a date prior to the foreclosure sales, and the balance of said fee amounting to $2,000 was paid at a date subsequent to said foreclosure sales. We would also submit that the attorneys' fees and appraisers' fees which total $11,600 are reasonable in view of the amount of services rendered and also in view of the amounts due under the deeds of trust, some $4,000,000. We would also note that the services of appellee's attorneys in connection with the hearing before the referee on the question of who should receive the funds in the hands of the receiver, and their services in connection with the application for review and this appeal, are also covered by the provisions of the deed of trust and are "for the purpose of protecting or enforcing the security" and an additional fee for these services would be a proper charge against the funds in the hands of the receiver.

As mentioned above, appellee believes that the fact that a portion of said fees were paid prior to the

foreclosure sales and the balance paid thereafter is irrelevant, although the referee was apparently of the opinion that any sums paid by appellee after the foreclosure sales were paid by it as "purchaser" and not as "beneficiary" under the deeds of trust. In his memorandum of November 30, 1965, the referee has cited the case of Penziner v. West American Finance Co. (1937), 10 Cal.2nd 160. This case was also cited by the alleged bankrupt in his memorandum to the referee on this issue, but we submit that the case actually supports appellee's position that its attorneys fees and appraisal fees are a proper charge against the funds in the hands of the receiver.

The Penziner case actually involved a question of whether or not usurious interest had been charged a borrower and in order to make this determination it was necessary for the court to determine whether certain charges made by the lending institution at the time of the foreclosure sale were proper charges. One of the charges made was for the services of attorneys required in connection with defending mechanic liens' suits involving the property. The record disclosed that the services rendered by the attorneys were rendered subsequent to the foreclosure sale and the California Supreme Court commented that there was no evidence that the trustee or the lending institution as beneficiary had

paid the costs or attorneys fees "or became liable for any costs or attorneys fees prior to said sale" on account of the mechanics lien action (p. 180). The court further noted that a sum paid for legal services in connection with the foreclosure of the deed of trust was a proper charge and one properly paid from the proceeds of the trustee's sale and one which should have been allowed by the trial court. We submit that the Penziner case is authority for the proposition that where the beneficiary has become liable for costs or attorneys fees prior to the foreclosure sale, that the sums so paid are a proper charge against the funds resulting from the trustee's sale, even if actual payment is not made by the beneficiary until a date subsequent to such sales. Accordingly, even under the authority relied upon by the referee and the alleged bankrupt, the sum of $11,600 was unquestionably a proper charge against the funds in the hands of the receiver.

Finally, each of the promissory notes here involved provides that the holder may charge and the maker agrees to pay up to one-fifth of 1% on the unpaid balance for each default, with a minimum of $10 for each default. The unpaid principal balance on all of the notes at the time of the defaults was approximately $3,750,000 and one-fifth of 1% of that amount is $7500. (R.p.88)

No part of this sum was included in the bids at the foreclosure sales and accordingly said amount remains unpaid and a proper charge against the funds in the hands of the receiver.

III

Only Those Fees Which Relate to The Creation of the Fund Should be Paid From the Fund.

The referee ordered that the attorney for the alleged bankrupt should be paid the sum of $2,150 out of the funds in the hands of the receiver. This payment was to be for the legal services rendered by him to the alleged bankrupt. Appellee respectfully submits that this award was improper, as determined by the District Court, and that the only awards which should be made out of said fund were to those whose services helped create such fund. The services of the attorney for the alleged bankrupt in no way contributed to the creation of that fund and should not be charged against such fund.

It is the general rule that the fees for the attorneys for the petitioning creditor, for the bankrupt, and for the receiver or the trustee, are regarded as expenses of general administration and are not deductible from the proceeds payable to a lienor unless

such services directly related to the preservation of the property subject to such lien. In this connection two potentially conflicting approaches are balanced: (1) The cost of protecting a fund in court is recognized as a dominant charge on that fund; (2) Administrative expenses in bankruptcy should be borne by the estate and a lien holder is entitled to the full value of his security, if possible, unimpaired by the bankruptcy litigation.

In re: Williams estate, 9th Cir. (1907)
156 Fed., 934.

Textile Banking Co. v. Widener
4th Cir. (1959), 265.

In the Williams case, the claimant had made various loans to the bankrupt which were secured by certain chattel mortgages upon the contents of the bankrupt's place of business. This equipment was sold by the receiver and in his account the receiver charged against those funds certain expenses, including a fee for the receiver and his attorney as well as certain expenses relating to the operation of the business of the bankrupt. The lien claimant objected to the allowance of those expenses, but they were allowed by the District Court; upon appeal, this Court stated the applicable rule as follows:

". . . By coming into the bankruptcy court, therefore, the holder of a valid

"lien upon the estate of a bankrupt comes into an appropriate place and into a court amply able to enforce and protect his rights. The enforcement of his lien in another court would entail upon the proceeds of the property upon which the lien exists the payment of the appropriate court costs; and so, in the enforcement of such lien in a court of bankruptcy, the proceeds of the property of the bankrupt upon which such lien exists is properly chargeable with the costs of such court appropriate to such enforcement, but with no other or further costs. They are not chargeable with the general costs of the administration of the bankrupt's estate, such as the services of a receiver in carrying on the business of the bankrupt, the expenses and losses of such business, the fees of the attorney for such receiver, the general fees of the trustee or those of his attorney. If so, the valid lien upon the estate of the bankrupt, which the bankruptcy act expressly declares shall be unaffected by any of its provisions, might very readily be destroyed, as it would

"unquestionably be, should such costs equal or exceed the proceeds in cases like the present, where the aggregate amount of the valid liens exceeds the proceeds of the entire estate of the bankrupt. In line with this ruling are the cases of "Stewart v. Platt, 101 U.S. 731, 739, 25 L. Ed. 816; In re Utt, 105 Fed. 754, 45 C.C.A. 32; In re Prince & Walter (D.C.) 131 Fed. 546, 552; In re Bourlier Cornice & Roofing Co. (D.C.) 133 Fed. 958, 963; Loveland on Bankruptcy (3d Ed) P. 775. See also, Collier on Bankruptcy (6th Ed.) p. 497." (emphasis added)

This decision was cited by this Court more recently, with approval, in the case of First Western Savings & Loan vs. Anderson (1958) 252 Fed.2d 544, 547. In the Textile Banking Company case, supra, this same rule was more recently stated by the 4th Circuit Court of Appeals. In that case, encumbered property was sold by the bankruptcy trustee and certain charges were properly allowed against the security fund covering costs in connection with the sale and the protection of the property pending the sale. However, an additional charge was allowed against the fund and in reversing such allowance, the Circuit Court stated the applicable

rule as follows:

". . . But where the Trustee has elected to sell the encumbered property he cannot intrench upon the amount of the secured debt for the payment of any of the expenses of administration, such as commissions and similar costs. Such costs can be taken only out of any surplus realized over and above the amount necessary to pay the secured debt. As stated in Remington on Bankruptcy, Sect. 2609; 'It is well settled that, ordinarily, general bankruptcy administration expenses are not chargeable against proceeds from the sale of assets covered by the mortgages or liens to the detriment of the lienholder or secured creditor.'"

"And in 6 Am. Jr. p. 1511, Sect. 1689, we find: 'A secured creditor need bear only the costs of enforcing his rights and the necessary expenses incurred in the preservation of the property pledged for the debt. A lien holder is not to be divested of his rights in the security by an allowance of commissions and other expenses, where the services for which they are allowed have no

"'relation to the security.'"

"And this appears to be the rule whether the sale by the trustee was consented to by the lienholder or not."

"In such a case the fund on which the debt is secured cannot be intrenched upon except for payment of the actual costs of selling the property, plus in some circumstances the expense, if any of preserving the encumbered property pending the sale."

The rule established by these cases is clear: A bankruptcy trustee or receiver takes property subject to existing liens and he cannot impair or deplete that lien by expenses which do not directly contribute to the protection and preservation of the liened property. Certainly no claim can be made that the charges of the attorney for the alleged bankrupt in any way preserved or protected the liened property.

The District Court found that the payment to the attorney for the alleged bankrupt was for the services rendered by him to the alleged bankrupt and that there was no indication in the record that such services in any way contributed to the creation or the preservation of the funds in the hands of the

receiver. At the hearing before the District Court, the attorney for the alleged bankrupt waived the opportunity offered to him to present further evidence for the purpose of establishing if his services did contribute to the creation of the funds in the hands of the receiver. (Fdg. 30, R.117)

Finally, the attorney for a bankrupt is normally entitled only to a modest fee for preparing the schedules in bankruptcy, not for all the services he may have rendered to the bankrupt. Therefore, even if this Court should disagree with the District Court and determine that the attorney for the bankrupt is entitled to some fee out of the funds in the hands of the receiver, the fee of $2150 awarded by the referee was too high in any event.

CONCLUSION

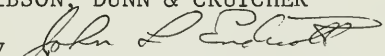
Appellee submits that the authorities hereinbefore cited establish beyond any question that the decision of the District Court was correct and that the rents collected by the receiver were collected by him for the benefit of appellee, were the property of appellee, and were not the property of the alleged bankrupt. As stated by the 8th Circuit Court of Appeals in the Mortgage Loan case, supra, at page 34,

"such funds never became a part of the bankrupt estate and are therefore not subject to any claims for fees which might otherwise be made against assets of the bankrupt estate." Even if this Court should conclude that the funds were not actually the property of appellee, then nevertheless appellee is entitled to receive from that fund reimbursement for those items which were not included in its bids at the foreclosure sales. These unreimbursed items include the sum of $5600 incurred and paid as attorneys' fees, plus an additional fee for their services in connection with the Application for Review and this appeal, the sum of $6,000 incurred and paid as appraisal fees, and the default charge of one-fifth of 1% of the unpaid balances amounting to $7500. Finally, said fund should not be charged for any services rendered by the attorney for the alleged bankrupt.

WHEREFORE, appellee submits that the order of the District Court granting the Application for Review and reversing portions of the referee's orders should be affirmed.

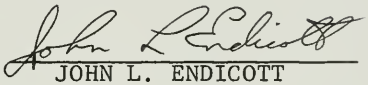
Respectfully submitted,

GIBSON, DUNN & CRUTCHER

By 
John L. Endicott

CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.



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